

CHAPTER 9

CONCLUSIONS

USDA's Farm Service Agency operates a system designed to elicit low bids for the delivery of large volumes of a limited number of food products. The system largely reaches those goals. The evidence in chapter 8 shows that FSA prices are substantially below those obtained by private sector buyers; chapter 7 supports those findings by showing that agricultural commodity purchase costs represent high shares of the prices for FSA food product purchases, suggesting that processing margins are quite low. By implication, FSA stretches USDA budget dollars by purchasing substantial volumes of food products for any given budget allocation.

As the experience of DoD and the VA show, low prices are only one of the things that ultimate consumers want from their food distribution system. Along with nutritional needs, they are also interested in timely delivery and product variety. FSA does not act as a full-line food distributor for its clients, and hence, does not focus on wide variety and rapid delivery. Rather, it fills a niche by providing the opportunity for clients to obtain large volumes of a few items at very favorable prices, and it fills that niche by limiting product variety and by responding more slowly to orders than a full-line distributor would. By saving clients money on USDA products, FSA can allow them to more effectively spend the rest of their budgets on a variety of products.

Nevertheless, FSA's actions can affect clients' realization of their several goals. Because of FSA's long lead times for delivery, client agencies must plan meals well in advance. When FSA deliveries arrive later than expected, meal plans are upset, meal quality can suffer,

and client agency costs can rise sharply when they must replace FSA's orders quickly. Moreover, USDA's product offerings, sometimes devised with a view toward surplus removal, do not always match client needs or expectations from USDA's niche service. As a result, even though FSA's strengths lie in the provision of large volumes of a relatively few low-priced items, reliable delivery and product variety still matter to clients, and the agency must be concerned with meeting client expectations of FSA in those areas.

The Role of Agricultural Prices

FSA bids are quite sensitive to movements in agricultural prices—far more sensitive to agricultural price movements than are general wholesale and retail food prices. There is an important implication of that finding: because agricultural prices tend to fluctuate widely, FSA's prices will fluctuate more widely over time than corresponding wholesale and retail prices. FSA prices will fall more than wholesale and retail prices when agricultural prices decline, and they will rise more rapidly than wholesale and retail prices when agricultural prices rise sharply. The gap between FSA and corresponding retail and wholesale prices, therefore, should be largest during periods of relatively low agricultural prices and smallest during periods of high agricultural prices. Because our data also suggest that FSA prices may be more sensitive to transport costs, the gap between FSA and corresponding retail and wholesale prices should also be highest in those regions that are close to agricultural production regions.

Chapter 6 shows that bids for FSA products rose along with agricultural prices in the later part of our study period, and that bids rose relative to FSA's constructed prices. That pattern suggests a possible problem in KCCO's calculation of constructed prices: in particular, because constructed prices seem less sensitive to underlying agricultural prices than bid prices are, constructed prices may not give enough weight to agricultural prices. The issue is important because KCCO uses its constructed prices to decide whether to cancel an auction, and shift orders to later auctions. While, the threat of cancellation can be useful (auction theory suggests that the threat can lead to more competitive bidding, and the threat of cancellation is credible only if it is used at times), but actual cancellations lead to lags in product deliveries, thereby imposing substantial costs on clients. FSA needs to guard against cancellation of auctions when constructed prices are unreliable guides. We therefore recommend that FSA review its procedures for calculating constructed prices, with a particular focus on the weight given to agricultural prices.

Competition

Competition matters, but it matters a lot only in some circumstances. Our statistical analysis of bidding shows that more bidders are consistently associated with lower prices on FSA products, but the effect of more bidders becomes rather small once an auction has two and three bidders. Most of the gains for FSA from competition come from adding a bidder in auctions where there would otherwise be only one bidder. As an approximate rule of thumb, FSA can do as much for its clients by finding a second bidder for a monopoly auction (reducing prices by 4-7 percent) as by finding four more bidders for an auction that already has two. Consequently, FSA should be most concerned about competition in those auctions that consistently attract a very small number of bidders. We recommend that FSA focus its efforts to add bidders for auctions that typically attract only one or two bidders.

Chapter 6 shows that the number of bidders in FSA auctions varies substantially by product and over time. Where are the most serious competitive problems? Seasonality is important for some products: for example, over three-quarters of monopoly auctions in flour occur in the fall, when mills operate near peak capacity. Monopoly auctions are also more likely among products with limited FSA volume—unusual package sizes and product characteristics.

In those cases, FSA can counteract monopoly by conveying accurate price information to clients—for example, that FSA's price advantages over commercial flour providers are weakest in the fall and strongest in other periods, or that FSA's price advantages are strongest in high-volume products. We recommend that FSA explore ways to counteract seasonal variations in monopoly by extending the experiment with rolling contracts, currently in use with cheese, to other products. At present, funding authorizations can constrain FSA's ability to use rolling auctions because money appropriated in one fiscal year must usually be spent in that year.

Participation in FSA bidding has a distinctive “all or nothing” character to it; bidders typically commit to being active in FSA auctions, in which case they bid actively each month on auctions for a variety of locations and products. Auction participation then does not typically decline because bidders reduce the number of auctions they are active in; rather, firms decide to get out of FSA bidding entirely. Our present research has not tried to uncover the reasons that firms decide to enter or leave FSA's bidding process, but the data we have developed do allow us to identify the firms that have entered and left the process during the period. Efforts to increase competition should inquire into the reasons for entry and exit by those firms, and the research should generate strategies to attract participation by more firms.

Effects of Purchase Volumes

Monthly FSA purchase volumes have dropped substantially as a result of changes in USDA commodity support programs. But declining volumes have not as yet had any substantive effects on FSA bids. Purchase volumes have only small direct effects on prices, and those effects are not always in the same direction. Moreover, changes in purchase volumes for individual products appear to have had little effect on competition (typically, bidder numbers fell and then rose during the period, while volumes fell consistently and sharply).

Monthly volumes have small effects on bids, and the direction of the effect varies with volume; increases in volume are first associated with declining prices, but then drive prices up slightly in very high-volume months. The data also show that markets respond to total USDA purchases (foreign and domestic), and not simply to domestic buys. The most important effects on prices occur in months in which there are large PL480

purchases; in those months, coincident large domestic purchases can lead to FSA price increases of 2-4 percent. The driving factor in these instances are PL480 purchases, which vary sharply from month to month. We recommend that FSA initiate strategies to get better prices on domestic flour and vegetable oil, either by smoothing PL480 purchases or by timing domestic purchases to avoid peaks in PL480 purchases.

Order volumes (the amount going to a specific destination in a specific order) have very small effects on prices. Larger orders generally draw more aggressive bidding, but prices only fall by less than 1 percent; combining orders into multiple truckloads yields very limited savings. Major gains in price likely come as one goes to truckload volumes from smaller orders, and FSA already acts to combine small orders into orders of at least truckload sizes.

We also recommend that FSA advise client agencies that they can generally save 1-2 percent on purchase prices if they are willing to accept delivery to major destination points within a State, rather than to locations that are rarely used for FSA deliveries.

Commercial Labels and USDA Inspection

The reliance on USDA labels and packaging shifts some risks of poor product quality away from the vendor and toward USDA, and consequently creates a need for USDA inspection. USDA inspection, along with occasional unusual packaging requirements, can raise vendor costs by 1-2 percent; USDA inspection and testing can also occasionally lead to lags in product delivery, which clients cite as a persistent problem. Some vendors, especially relatively small plants, cite inspection and packaging requirements as deterrents to participation in FSA auctions because of the effects on cost and on timely delivery of products.

The current system results in very competitive prices, and the insistence on USDA labels may contribute to the competition that leads to those prices; some firms may not wish to bid aggressively on their own branded products. In some products, in other words, the net effect of USDA labels and inspection may be lower prices. But insistence on USDA labels may, in other products, limit opportunities to obtain surplus stocks of commercially labeled products and may deter additional bidders from participating.

FSA currently purchases commercially labeled products in a few commodity categories. In highly oligopolistic markets with only a few vendors, FSA may be able to obtain more product variety and greater competition by opening auctions to commercially labeled products. The clear examples include the current experiments in ready-to-eat cereal and infant formula. Those two cases illustrate a dilemma for the agency. A principal argument for USDA labels is that they limit brand loyalty on the part of consumers and, therefore, allow for more competitive bidding, but brand loyalty is important in those two products (especially ready-to-eat cereal).

FSA's shift to purchase of commercial labels reflects the agency's judgment that the shift may introduce greater competition into two highly concentrated markets. But FSA also purchases products for other markets in which brand loyalty is far less important because the brands are never seen by ultimate consumers and because the products are used as ingredients in final servings, not as the serving itself. We recommend that FSA carefully evaluate its current experiments and consider a gradual expansion of commercial labels (especially including high-quality private-label and wholesalers' own-brand products), especially in products with limited existing brand loyalty and low vendor participation.

Service Quality

Client agencies cited four common complaints. The primary complaint, referred to earlier, related to unreliable delivery of products. This complaint has three major components: lags due to USDA inspection delays (typically at small plants), cancellation of auctions, and vendor noncompliance. FSA can improve reliability by reviewing procedures for cancellation and inspection (including labeling requirements), and by instituting a more effective system of contractual penalties for noncompliance.

A second common complaint referred to product selection: client agencies feel that surplus removal goals drive the selection and distribution of bonus commodities that clients frequently have little interest in. Third, complaints sometimes referred to deterioration of some products. Finally, and related to the first three, clients cited barriers to problem resolution.

USDA products follow a long distribution chain between ordering food and serving a meal: a client

places an order with USDA, which then arranges for production. A vendor manufactures the product, and arranges for delivery from the processing plant to a State warehouse or to another processing site. The product is then delivered to the client's central facilities before being distributed to dining facilities, where further preparation and holding may occur before serving. The client may interact with State government agencies in ordering and final delivery, and may be unaware that up to five different USDA agencies may be involved in their order for food.

FNS is developing a hotline system in an attempt to respond better to immediate client problems with agency deliveries. Larger issues, relating to program goals and design, are likely to arise in response to ongoing changes to Federal farm and food assistance policies.

Retention and Use of FSA Auction Data

FSA disposes of the electronic records of auctions after 1 year. The research for this report relied primarily on paper reports, the data from which were re-entered into an electronic format. Electronic data retention grows easier and cheaper every year, and so do methods for analyzing data. Moreover, because of steady improvements in the electronic retention and analysis of data, undergraduate business and economics majors now routinely learn almost all the techniques that were used in this analysis, and high school students are being introduced to techniques of graphing and summarizing statistical data. In short, KCCO commodity analysts should, in the future, be able to easily call up 5 years' worth of past auction data (for example); they should be able quickly to summarize key data patterns, and can easily be provided with expert summaries of more subtle issues. They should be able to use that information in making auction decisions and in delivering timely information and advice to client agencies. We recommend that KCCO's future strategy for information technology include steps to retain electronic auction records and to develop those records into easily accessible databases.